

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
MCI TELECOMMUNICATIONS CORP. :
for Revision of a Determination or for Refund :
of Sales and Use Taxes under Articles 28 and 29 :
of the Tax Law for the Period December 1, 1984 :
through December 31, 1985. :

In the Matter of the Petition :
of :
MCI EQUIPMENT CORP. :
for Revision of a Determination or for Refund :
of Sales and Use Taxes under Articles 28 and 29 :
of the Tax Law for the Period September 1, 1981 :
through November 30, 1984. :

DETERMINATION

In the Matter of the Petition :
of :
MCI LEASING, INC. :
for Revision of a Determination or for Refund :
of Sales and Use Taxes under Articles 28 and 29 :
of the Tax Law for the Period June 1, 1981 :
through November 30, 1984. :

Petitioners, MCI Telecommunications Corp., MCI Equipment Corp., and MCI Leasing, Inc., 1133 19th Street, N.W., Washington, D.C. 20036, filed petitions for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the respective periods December 1, 1984 through December 31, 1985, September 1, 1981 through November 30, 1984 and June 1, 1981 through November 30, 1984 (File Nos. 806323, 806324 and 806325).

On January 12, 1990 and January 31, 1990, respectively, petitioners by Shea & Gould

(Roger Cukras, Esq., of counsel) and the Division of Taxation by William F. Collins, Esq. (James Della Porta, Esq., of counsel) consented to have the petitions determined on submission without hearing, with all briefs due by July 3, 1990. After due consideration of the record, Marilyn Mann Faulkner, Administrative Law Judge, renders the following determination.

ISSUE

Whether petitioners have established reasonable cause warranting a remittance of the penalty imposed for their failure to file and pay sales and use taxes with regard to telecommunication services and certain tangible personal property that was purchased or leased.

FINDINGS OF FACT

Petitioners are affiliated corporations engaged in the telecommunications business. MCI Telecommunications Corp. ("MCI Telecom") is an operating company which provides both interstate and intrastate long distance telephone service. MCI Equipment Corp. ("MCI Equipment") and MCI Leasing, Inc. ("MCI Leasing") purchase equipment and lease it back to MCI Telecom.

The Division of Taxation performed separate audits of MCI Telecom, for the period September 1, 1977 through August 31, 1981, MCI Leasing, for the period June 1, 1977 through May 31, 1981, and MCI Equipment, for the period June 1, 1977 through May 31, 1981. As a result of these first audits, petitioners were assessed additional tax due in the respective amounts of \$1,115,322.56 plus penalty and interest (MCI Telecom Notices S811130002R and S811130001R, dated November 30, 1981), \$465,740.79 plus penalty and interest (MCI Leasing Notice S811214001R, dated December 14, 1981), and \$227,508.97 plus penalty and interest (MCI Equipment Notice S811214000R, dated December 14, 1981).

With regard to MCI Telecom, the tax assessment was based on unreported sales concerning intrastate telephone calls, installation charges and subscription fees and on unreported taxable assets that were purchased or leased. With regard to MCI Leasing and MCI Equipment, the Division found sales tax due based on their failure to file sales tax returns (ST-100s) concerning the leasing of tangible personal property to MCI Telecom.

On March 1, 1982, the former Tax Appeals Bureau received petitions filed by MCI Telecom challenging the tax assessment in these four notices.

In December of 1984, petitioners and the Division of Taxation reached a settlement whereby the tax deficiency was reduced by \$330,322.50. This reduction recognized a cancellation of the tax related to installation fees and an adjustment to the taxes due on purchased and leased assets. In addition, the Division agreed to cancel the penalty on the tax assessment and reduce the interest to minimum interest. On December 26, 1984, petitioners withdrew their petitions challenging the Division's tax assessment concerning these first audits.

The Division of Taxation conducted a second audit of the three petitioners. MCI Telecom was audited for the period September 1, 1981 to December 31, 1985; MCI Equipment was audited for the period September 1, 1981 to November 30, 1984; and MCI Leasing for the period June 1, 1981 to November 30, 1984.¹

The auditor found that MCI Telecom had not made the appropriate corrections after the first audit. The Division assessed a tax due based on unreported taxable items such as intrastate calls and purchases of tangible personal property used in New York State. Among the items of property purchased were furniture and fixtures, motor vehicles and data processing equipment that totalled \$7,426,497.00² for the audit period September 1, 1981 to December 31, 1985. The auditor also found that MCI Leasing and MCI Equipment had unreported taxable sales again based on tangible personal property that was leased to MCI Telecom.

Initial audit results were presented to petitioners so that they could take advantage of the Tax Amnesty Program. In January 1986, MCI Telecom applied for and obtained tax amnesty

¹On November 30, 1984, MCI Equipment and MCI Leasing were merged into MCI Telecom.

²In their reply brief, dated July 2, 1990, petitioners state that the total dollar amount of purchases with regard to motor vehicles, furniture and fixtures was approximately \$1.8 million and not \$7,426,497.00 as stated in an affidavit submitted by the Division's auditor (Exhibit BB). Petitioners have not submitted any other proof to support this allegation.

for its sales and use tax liabilities for the period of the second audit up to December 31, 1984, periods covered by the Amnesty Program (see, L 1985, ch 66, § 1[a]). MCI Leasing and MCI Equipment also applied for and obtained tax amnesty with regard to portions of the auditor's results for their second audit periods.

In December of 1986, petitioners were each issued a Statement of Proposed Audit Adjustment (SPAA) for the additional tax due plus penalty and interest remaining after payment under the amnesty program. The items covered by MCI Telecom's SPAA included purchases of microwave towers, repeater sites for microwave transmissions, shelters for equipment, generators, batteries, test equipment and telecommunication services that

were not resold. The SPAA also included New York City sales tax on telephone equipment exempt from State sales tax pursuant to Tax Law § 1115(a)(12) and nontelecommunication equipment such as furniture and fixtures for the post amnesty component of the 1981-1985 audit period. The SPAAs of MCI Leasing and MCI Equipment included unreported sales concerning lease arrangements with MCI Telecom of tangible personal property. Petitioners paid the respective tax assessments plus simple interest but declined to pay the penalties and statutory interest assessed on the taxes due.

The Division issued to petitioners three notices of determination and demands for payment of sales and use taxes due dated February 27, 1987: Notice S870227000R to Telecom (\$204,180.07 plus interest for the period December 1, 1984 through December 31, 1985), Notice S870227006R to Equipment (\$10,125.75 plus interest for the period September 1, 1981 through November 30, 1984) and Notice S870227007R to Leasing (\$122,448.94 plus interest for the period June 1, 1981 through November 30, 1984). The notices assessed only penalties plus statutory interest against the respective petitioners based on the tax assessments contained in the SPAAs that had already been paid.

On November 18, 1988, the three petitioners filed separate petitions challenging their respective notices of determination.

In May 1989, MCI Telecom filed a request for an advisory opinion seeking the Department of Taxation and Finance to exempt certain equipment from sales and use taxes as telephone central office equipment pursuant to section 1115(a)(12) of the Tax Law.

SUMMARY OF THE PARTIES' POSITIONS

Petitioners argue that the penalties imposed as a result of the second audit period from 1981 to 1985 should be excused, because they had reasonable cause to believe that a large percentage of the underpayment of tax related to certain equipment that was exempt from sales and use taxes. Specifically, petitioners assert that some of the equipment was exempt from tax as "telephone central office equipment" under section 1115(a)(12) of the Tax Law or, alternatively, was exempt from tax because it was purchased for resale and qualified as "real" property inasmuch as such equipment was affixed to the ground when subsequently leased. Petitioners argue that they have met the criteria set forth in 20 NYCRR 536.5(c)(4) and (d)(2) for establishing reasonable cause and the absence of willful neglect as evidenced by their 1981 petition challenging the first audit and their request for an advisory opinion on this issue in May 1989.

The Division of Taxation claims that petitioners have not satisfied either the reasonable cause or absence of willful neglect criteria. Counsel for the Division points out that petitioners had not sought to clarify the tax status of the equipment in question either before or during the period under review and that a claim of confusion or ignorance of the law is no excuse. Furthermore, counsel asserts that petitioner's filing history should be considered; that Telecom was clearly on notice by December 1984 as to its tax liability on equipment purchases and, therefore, its failure to report or remit tax due on these purchases during 1985 was inexcusable.

CONCLUSIONS OF LAW

A. Section 1145(a)(1)(i) of the Tax Law states that any person failing to pay over any tax to the Tax Commission within the time required by Article 28 "shall" be subject to a penalty on the amount of tax due. The Tax Commission will remit all of the penalty if it determines that a taxpayer's failure to pay the tax in a timely manner was due to "reasonable cause and not due to

willful neglect" (Tax Law § 1145[a][1][iii]; see, 20 NYCRR 536.5). The taxpayer has the burden of demonstrating that a penalty was improperly assessed (Matter of LT&B Realty Corp. v. New York State Tax Commission, 141 AD2d 185, 535 NYS2d 121, 122).

B. Relying on 20 NYCRR 536.5(c)(4), petitioners argue that their 1981 petitions challenging the first audits constitute a ground for reasonable cause not to pay sales or use taxes in the subsequent period covered by the second audit. Section 536.5(c)(4) states that reasonable cause may be established during the pendency of a petition to the Division of Tax Appeals if (1) the petition involves a question of whether to file, collect and remit sales tax or to file and pay use tax, (2) the petition is not based on a position which is frivolous nor intended to delay or impede the administration of the Tax Law, and (3) the facts and circumstances for such taxable periods are identical or virtually identical to those of the taxable period covered by the petition.

C. MCI Leasing and MCI Equipment have established grounds for reasonable cause under the criteria set forth in 20 NYCRR 536.5(c)(4). Their 1981 petitions challenging the first audit were pending, until they were withdrawn on December 26, 1984, during the second audit period ending November 30, 1984. The exemption arguments raised in the 1981 petitions are substantially similar to the arguments raised in the present petitions and both parties agree that the same items that were not reported as taxable during the first audit were not reported during the second audit. Although the Division's counsel does not argue that petitioners' positions in the petitions are frivolous, he does assert that petitioners' claim that they were confused about the tax status of telephone equipment is "merely an after the fact rationale for conduct which had other motivation." Taking the record as a whole, however, it appears that the legal position asserted in the 1981 petitions was not "frivolous" or designed "to delay or impede" the administration of the Tax Law, but instead, represented arguable claims, regardless of the ultimate outcome on the merits.

D. Because the 1981 petitions were no longer pending during the time period for which

MCI Telecom was assessed a penalty (December 1, 1984 - December 31, 1985),³ Telecom has not established reasonable cause under 20 NYCRR 536.5(c)(4).

E. Moreover, MCI Telecom has not established reasonable cause under 20 NYCRR 536.5(c)(5).⁴ That section provides, in addition to the criteria set forth in subsections 1 through 4 of 20 NYCRR 536.5(c), that "[a]ny other cause for delinquency which would appear to a person of ordinary prudence and intelligence as a reasonable cause for delay and which clearly indicates an absence of willful neglect may be determined to be reasonable cause. Ignorance of the law, however, will not be considered a basis for reasonable cause." From the record, there is no doubt that whatever excuses MCI Telecom may have arguably had initially for failing to

report the items subject to sales and use tax -- i.e., newness of the business, honest belief that the items were exempt as telephone central office equipment, sale for resale or real property -- its continued failure to comply with the audit by not reporting the same taxable items after its withdrawal of the 1981 petition constituted disingenuous behavior that is inexcusable (see, Matter of S.H.B. Supermarkets v. Chu, 135 AD2d 1048, 522 NYS2d 985). Once Telecom was informed that such items were taxable, it could no longer rely, if it ever could, on its mistaken belief that these items were exempt. Notwithstanding the fact that petitioner Telecom may not have conceded its position when it withdrew the 1981 petition, it did nothing to preserve its claims with the Department of Taxation and Finance until it requested an advisory opinion in 1989. Telecom's request for an advisory opinion in 1989 does not constitute reasonable cause for not filing such taxes in 1984-1985. During the interim, Telecom had an obligation to report

³The fact that there was a one-month overlap (1981 petitions withdrawn on December 26, 1984) is not relevant inasmuch as Telecom failed to report sales and use tax at the end of the first quarter, which occurred after the 1981 petitions were no longer pending.

⁴While Telecom argues that it acted in good faith under 20 NYCRR 536.5(d)(2), that provision only applies to penalties imposed under Tax Law § 1145(a)(1)(vi). The appropriate regulation in the present circumstances is 20 NYCRR 536.5(c)(5). However, petitioner has not met either standard.

these items claimed by the Division to be subject to sales and use tax. At that time, MCI Telecom was well aware that these items were to be reported as taxable despite its continued belief that such items should be exempt. Thereafter, it could have applied for a refund rather than continuing its cat-and-mouse game with the Division during the latter part of the second audit period. Thus, there is no merit to MCI Telecom's claim that it made an honest mistake. Such a mistake would not appear to be reasonable to a person of ordinary prudence and intelligence let alone to MCI Telecom in light of its experience, knowledge and education (compare, LT&B Realty v. State Tax Commission, *supra*, 535 NYS2d at 123; Matter of Jack La Russa d/b/a Jack's Pizza, State Tax Commission, April 4, 1986). Moreover, while petitioner claimed that an "overwhelming majority" of the equipment in question was exempt, it failed to explain why other items not claimed to be exempt were not reported (*see*, Finding of Fact "9"). Furthermore, the Division's counsel noted that even if petitioner were correct in claiming an exemption as central office equipment under Tax Law § 1115(a)(12), this exemption did not apply to local sales tax that was owed to New York City (Tax Law § 1107[b]). In response to this point, MCI Telecom states, in brief, that the fact it did not pay such local tax is irrelevant because if such tax had been paid it would have been entitled to a credit against its New York City general corporations tax. Telecom's response misses the point and merely underscores the absence of reasonable cause for its failure to report local taxes. In sum, MCI Telecom has not made even a plausible argument warranting its continued failure to report sales and use taxes after withdrawal of the 1981 petitions (*see*, Matter of S.H.B. Supermarkets v. Chu, *supra*; *see also*, Matter of Auerbach v. State Tax Commission, 142 AD2d 390, 536 NYS2d 557, 561; Matter of LT&B Realty Corp. v. New York State Tax Commission, *supra*).

F. The petitions of MCI Equipment and MCI Leasing are granted and the notices of determination and demands for payment of penalties plus interest issued to these petitioners are cancelled in accordance with Conclusion of Law "C". The petition of MCI Telecom is denied and the Notice of Determination and Demand dated February 27, 1987, issued to MCI Telecom, is sustained.

DATED: Troy, New York

ADMINISTRATIVE LAW JUDGE